

**CITY OF NEWTON, MASSACHUSETTS**

**MANAGEMENT LETTER**

**JUNE 30, 2004**

To the Honorable Board of Aldermen and Mayor  
City of Newton, Massachusetts

In planning and performing our audit of the basic financial statements of the City of Newton, Massachusetts (City) for the fiscal year ended June 30, 2004, we considered the City's internal control in order to determine our auditing procedures for the purpose of expressing an opinion on the basic financial statements and not to provide assurance on internal control.

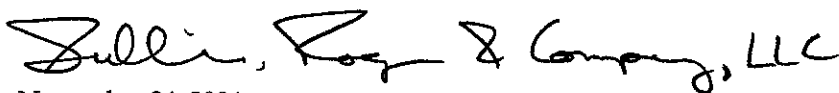
We noted certain matters involving the internal control and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control that, in our judgment, could adversely affect the City's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. Our consideration of internal control was for the limited purpose described in the preceding paragraph and would not necessarily disclose all matters that might be reportable conditions. In addition, because of inherent limitations in internal control, misstatements due to error or fraud may occur and not be detected by such controls.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of internal control would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe that the conditions identified as reportable conditions in the accompanying memorandum are material weaknesses.

During our audit we also became aware of several matters that are opportunities for strengthening internal controls and operating efficiency. The memorandum that accompanies this letter summarizes our comments and recommendations concerning the reportable conditions (considered material weaknesses) and other matters. This letter does not affect our report dated November 24, 2004, on the financial statements of the City.

The accompanying comments and recommendations are intended solely for the information and use of management and should not be used by anyone other than these specified parties.

We will review the status of these comments during our next audit engagement. We have already discussed these comments and suggestions with City personnel, and we will be pleased to discuss them in further detail at your convenience, to perform any additional study of these matters, or to assist you in implementing the recommendations.

Sullivan, Ross & Company, LLC

November 24, 2004

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CITY OF NEWTON, MASSACHUSETTS

MANAGEMENT LETTER

JUNE 30, 2004

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## **Reportable Conditions Considered to be Material Weaknesses**

### **Reconciliation of Cash and Accounts Receivable**

#### Comment

As part of our audit we considered the City's financial systems of internal control and identified the following:

- Cash was not reconciled timely between the Treasurer's cashbook and the general ledger (maintained by the Comptroller) during the fiscal year. June 30, 2003 cash was not reconciled until March 2004, or nine months after the close of the prior fiscal year. As a result, the fiscal year 2004 monthly reconciliations were in significant arrears.
- Individual bank reconciliations were not performed timely during the fiscal year and reconciliations of the vendor and payroll bank accounts were not performed at all.
- Reconciling items are not investigated and/or resolved timely. For example, we observed one instance where a deposit made during May 2004 was not recorded by the Treasurer or Comptroller until November of 2004.
- Accounts receivable (i.e., real estate, personal property, etc.) reconciliations between the Treasurer/Collector and the Comptroller were not performed timely during the fiscal year. These reconciliations primarily occurred during the final quarter of fiscal year 2004.

Failure to perform these important internal control functions in a timely manner inhibits the City's ability to ensure that cash transactions are properly recorded, summarized and processed through the accounting system. Therefore, financial reports generated from the accounting system cannot be relied upon and the opportunity for fraudulent activity exists.

As a result of the cash reconciliation condition identified above, the City contracted with our firm (prior to the City selecting us as independent auditor) to assist in the reconciliation of cash as of June 30, 2003. As part of this process, we provided guidance regarding new policies and procedures related to the reporting of cash receipts to the Comptroller's office and the recording of transactions in the Treasurer's cashbook.

Since these conditions existed during fiscal year 2004, we made inquiries regarding their status through the date of this report. Our inquiries identified the following:

- Cash was reconciled between the Treasurer's cashbook and general ledger through September 2004 and the October 2004 reconciliation was substantially complete.
- Excluding the vendor and payroll bank accounts, bank reconciliations were substantially completed through September 2004.
- Accounts receivable reconciliations were completed for July 2004.

### Recommendation

Based on our inquiries identified above, it appears that the reconciliation of cash between the general ledger and Treasurer's cashbook has improved subsequent to year-end. We recommend that management continue its current progress and strive to reconcile cash monthly between the general ledger and Treasurer's cashbook no later than 30 days after the end of the previous month.

The lack of payroll and vendor bank account reconciliations limits the assurance that cash disbursements processed by the Treasurer/Collector's office agree with expenditures (payroll and vendor warrants) processed through the general ledger. These reconciliations (and all bank reconciliations) are critical to the complete and accurate reconciliation of cash. We recommend that the Treasurer/Collector's office implement procedures to perform all bank reconciliations, including the investigation and resolution of reconciling items, no later than 30 days after the end of the previous month.

Subsequent to year-end, the Treasurer/Collector has developed written procedures for the reconciliation of accounts receivable balances. We recommend that an employee(s) of the Treasurer/Collector's office be assigned to complete the reconciliation of accounts receivable between the general ledger and Collector's detail no later than 30 days after the end of the previous month.

Implementation of these recommendations will alleviate the material weaknesses identified and strengthen the overall system of internal control.

### Management's Response

We agree that progress has been made on the timely reconciliation of cash and accounts receivable and we are committed to a timely implementation of these recommendations. The Treasurer's cash reconciliation begins monthly from the Treasurer's Quickbooks cash to the Comptroller's general ledger cash balance and then the Treasurer's Quickbooks cash to the bank statements. Additional staff will be assigned to assist in this area. The accounts receivable reconciliation process has also been assigned to other staff and will be done on a monthly basis at the earliest time possible.

## **Other Matters**

### **Financial Policies and Procedures Manual**

#### Comment

We believe that preparation of a formal policy and procedures manual would improve and standardize the City's financial policies and procedures. Inherent in any organization that operates without formalized written procedures are inconsistencies in everyday policies and procedures. The number of such inconsistencies can be minimized by the written codification of policies and procedures and insistence on adherence to them.

Such a manual should include policies and procedures relative to all financial functions and processes, including, but not limited to, the following:

- Cash receipts
- Purchase orders
- Cash disbursements
  - Payroll
  - Vendor
- Administration of grants
- Administration of student activity funds
- Personnel (i.e., hiring, payroll and related changes, etc.)
- Month-end and year-end closing procedures

The manual should also clearly define the objectives, responsibilities and authorizations for all employees/job positions.

The use of written policies, procedures, and job descriptions in conjunction with specific assignment of responsibilities would increase supervisory personnel's effectiveness. Such written documents would decrease the time spent on supervision of clerical personnel and in attempts to define job responsibilities on each occasion of employee turnover.

#### Recommendation

We recommend that management develop and implement a formal financial policies and procedures manual. We also recommend that each section of the manual be approved by the Finance Committee.

#### Management's Response

The Comptroller's Office will begin the process of documenting all accounting and financial reporting policies and procedures in 2005, with the ultimate objective of publishing all such policies and procedures on the City's intranet site within the next two years.

## Fraud Risk Assessment

### Comment

The opportunity to commit and conceal fraud exists where there are assets susceptible to misappropriation and inadequate controls exist to prevent or detect the fraud. All municipalities should perform a risk assessment to identify, analyze and manage the risk of asset misappropriation. Risk assessment, including fraud risk assessment, is one element of internal control. The City, like most Massachusetts municipalities, does not adequately perform this assessment.

The fraud risk assessment can be informal and should be performed by a management-level employee who has extensive knowledge of the City's operations. Ordinarily, the management-level employee would conduct interviews or lead group discussions with personnel who have extensive knowledge of the City's operations, its environment, and its processes. The fraud risk assessment process should consider the City's vulnerability to misappropriation of assets. When conducting the assessment, the following questions should be considered:

- What individuals have the opportunity to misappropriate assets?
- Are there any known pressures that would motivate employees with the opportunity to misappropriate assets?
- What assets are susceptible to misappropriation?
- Are there any known internal control weaknesses that would allow misappropriation of assets to occur and remain undetected?
- How could assets be stolen?
- How could potential misappropriation of assets be concealed?
- What factors might indicate that the City has a culture or environment that would enable management or employees to rationalize committing fraud?

Once areas vulnerable to fraud have been identified, a review of the City's systems, procedures, and existing controls related to the identified areas should be conducted. The City should consider what additional controls (if any) need to be implemented to reduce the risk of fraud.

There are two basic types of controls—those that are designed to address specific types of fraud, and those that are more general in nature. Some examples of general controls that reduce an employee's ability to commit fraud without detection include the following:

- Requiring Periodic Job Rotation and Mandatory Vacations
  - When an employee stays in the same position for a long period and has few absences, an opportunity exists for that employee to design and commit fraud schemes. Requiring key employees to rotate jobs periodically or to transfer to different job functions is one way to address this fraud risk. Requiring all employees to take an annual vacation, during which time others perform their job functions, also makes it more difficult for an employee who is committing fraud to continue concealing the fraud scheme.
- Implementing an Employee Hotline
  - Tips and complaints from fellow employees or vendors have enabled many companies to discover occurrences of fraud. Anonymous telephone hotlines allow honest employees and vendors who may fear retribution from fraud perpetrators to report unethical behavior without risking exposure. If the City does not want to establish and maintain a hotline, it can contract with the Association of Certified Fraud Examiners ([www.cfenet.com](http://www.cfenet.com)) or another vendor to provide this service.



Examples of controls to prevent or detect specific types of fraud include the following:

- Financial and Operating Performance Reviews
  - Performance reviews are comparisons of financial information to operating data, such as cash receipts to registration forms. Investigating significant differences from expected results can uncover indications of fraud.
- Independent Checks
  - Independent checks test another employee's work, such as by having an independent employee re-perform or test an employee's work.
- Separation of Duties
  - Separation of duties is one of the most effective controls to prevent or detect misappropriations of assets. When possible, incompatible duties should be performed by different employees. For example, the responsibility for authorizing transactions, recording transactions, and maintaining custody of assets should be assigned to different employees to the extent possible.
- Access and Authorization Controls
  - These controls are designed to ensure that only appropriate employees can enter into transactions or have access to City assets, documents, and records. Employees cannot steal assets they do not have access to, and they cannot alter documents or records to conceal fraud without access to those items. Examples of these types of controls include password protection of computer files and physical safeguards on assets susceptible to theft (for example, safes for cash and security measures for inventory).

When assessing the City's internal control, the relationship between the nature and extent of fraud controls recommended and the cost of implementing those controls should always be considered. For example, instead of trying to prevent fraud, the City may choose to use more detective controls to ensure that the fraud is identified and corrected in a timely fashion. Because detective controls are performed after the original transaction occurs, they may be easier to implement and more cost effective. However, fraudulent activity can cost the City more than the monetary losses as there is a cost related to the investigation of the fraud.

### Recommendation

We recommend that management develop and implement a fraud risk assessment program to identify, analyze, and manage the risk of asset misappropriation.

### Management's Response

The City of Newton currently has many procedures and safeguards in place to prevent fraud and the theft of money, equipment, and other property. For example, the City uses a detailed system of passwords and security checks to limit computer access to financial and personnel records. We also segregate duties within and between departments so that individuals who initiate expenditures cannot also approve them and vice versa.

The suggestions in the management letter give us the opportunity to review these procedures and improve upon them. The Chief Budget Office will convene discussions with senior members of the city and school departments responsible for the handling of cash and valuable or sensitive information to discuss a fraud assessment program and the examples cited in the management letter.

## Federal Education Grants Administration and Accounting

### Comment

We identified the following related to the administration and accounting of federal education grants:

- The School Department does not maintain the required documentation, as prescribed in OMB Circular A-87, *Cost Principals for State, Local and Indian Tribal Governments*, for salaries charged to federal special education (SPED), Title I Distribution and Comprehensive School grants. As a result, the grants are not in compliance with the allowable cost/cost principles requirements and are reported as findings (considered material weaknesses) in the Reports on Federal Award Programs.
- Financial reports submitted by the School Department to the Massachusetts Department of Education (DOE) were not completed based upon expenditures processed and recorded in (or reconciled to) the City's general ledger, which is not in compliance with federal grant requirements. This condition is reported as a finding in the Reports on Federal Award Programs.

### Recommendation

We recommend that procedures be implemented to comply with the cost circular (A-87) identified above. For employees that work solely on federal award programs, periodic certifications that the employees worked solely on that program for the period covered by the certification must be completed semi-annually and signed by the employee or supervisory official having first hand knowledge of the work performed by the employee. For employees that work on both federal programs and other non-grant related activities, personnel activity reports must be maintained that (1) reflect an after-the-fact distribution of the actual activity of the employee, (2) account for the total activity for which the employee is compensated, (3) are prepared at least monthly and coincide with one or more pay periods, and (4) must be signed by the employee.

We recommend that all of the City's grant administrators be familiar with OMB Circular A-87, *Cost Principals for State, Local and Indian Tribal Governments*, and all other federal compliance circulars and specific grant requirements.

We recommend that procedures be implemented to reconcile financial reports submitted to the Massachusetts DOE to the general ledger prior to their submission.

### Management's Response

As of September 1, 2004, the school district has adopted a monthly Time and Effort Reporting procedure for all staff funded in whole or part by federal funds. The new procedure brings the school district in compliance with OMB Circular A-87.

The School Department Grants Office has worked closely with the City Comptroller's office to implement new processes to ensure that the general ledger reflects actual grant spending in a timely manner. In addition, as of September 1, 2004, the Grants Office has implemented a policy such that financial reports reflect the general ledger.

## **Student Activity Funds**

### Comment

The City's elementary schools have not adopted the student activity fund law as defined in Chapter 66 of the Acts of 1996 (Act). In summary, the Act requires the following:

- The School Committee to authorize School Principals to receive funds in connection with the administration of student activities.
- Student activity funds to be deposited with the Treasurer into a separate interest bearing account (Student Activity Agency Account).
- Interest earned on the Student Activity Agency Account to be retained by the fund and disbursed at the discretion of the School Committee.
- In addition to the Student Activity Agency Account, the School Committee may authorize School Principals to establish a separate checking account (Student Activity Checking Account), which may only be used to disburse funds for the exclusive benefit of student activities.
- The School Committee to establish a maximum amount to be maintained in the Student Activity Checking Account.
- Funds, up to the maximum amount authorized by the School Committee, to be transferred from the Student Activity Agency Account to the Student Activity Checking Account (via the City's warrant process) to initially fund the Student Activity Checking Account.
- Periodically and to the extent funds are available in the Student Activity Agency Account, the City to reimburse the Student Activity Checking Account through the City's warrant process.

### Recommendation

We recommend that all student activity funds be maintained in accordance with the Act.

### Management's Response

Since fiscal year 2000, the Bowen Elementary School Student Activity Account has been established in accordance with Chapter 66 of the Acts of 1996. This has served as a pilot project for the elementary student activity accounts. The Horace Mann Elementary School does not have such an account; the PTO collects and disburses student activity monies. The Business Services Office will work with the elementary principals to bring any accounts into compliance with the regulations during fiscal year 2005.

## **Old Outstanding Checks**

### Comment

The vendor and payroll outstanding checklists maintained by the Treasurer include many checks greater than three (3) months old totaling approximately \$600,000. Typically, checks greater than three (3) months old reflect checks that have been void, lost, misplaced or stolen. There is currently no process/procedure in place to investigate and resolve the status of these checks.

### Recommendation

We recommend that the Treasurer/Collector's office implement monthly procedures to investigate and resolve outstanding checks greater than three (3) months old. Implementation of this recommendation will strengthen internal controls over cash disbursements.

### Management's Response

We agree with the recommendation of implementing a regular process of investigating and resolving old outstanding checks. Full staffing in the department occurred in late October 2004. As of the date of this management letter, we have begun the process by starting with the oldest outstanding checks one calendar year at a time, and working towards a more timely resolution of these matters.

## **Unauthorized Bank Accounts Using the City's Tax Identification Number**

### Comment

We identified eight bank accounts that are using the City's tax identification number that are not authorized by the Treasurer. Usually these accounts represent quasi-governmental organizations, such as parent teacher organizations, booster clubs, etc. However, since these accounts are maintained under the City's tax identification number, the City is at risk if fraudulent activities were to occur in any of these accounts. Additionally, the Treasurer should have signature authority on all bank accounts maintained under City's tax identification number and the activity related to the bank accounts should be recorded on the general ledger.

### Recommendation

We have provided a list of the unauthorized bank accounts to the Treasurer/Collector. We recommend that the Treasurer/Collector contact the related banks to begin the process of closing all of the unauthorized bank accounts.

### Management's Response

We agree with the recommendation and will aggressively work to eliminate all eight accounts by closing these accounts or having the organizations take the City's TIN off of the accounts in question.

## **Implementation of GASB Statement #34 Infrastructure Reporting Requirements**

### Comment

During fiscal year 1999, the Governmental Accounting Standards Board (GASB), which is the standard-setting body for establishing governmental accounting and financial reporting principles, issued Statement #34, *Basic Financial Statements – and Management’s Discussion and Analysis – for State and Local Governments*. This statement, which the City implemented during fiscal year 2002, established new financial reporting standards for state and local governments.

Allowable under the provisions of GASB Statement #34, the City elected to defer the retroactive reporting requirement of certain infrastructure assets (e.g., roads, bridges, sidewalks and similar items) until fiscal year 2006. As of the date of our report, the City had not finalized the retroactive accounting of its infrastructure assets.

### Recommendation

We recommend that management develop a plan to retroactively account for its general infrastructure assets by the required reporting deadline of fiscal year 2006.

### Management’s Response

Pre 2002 infrastructure capital asset work is approximately 90% complete, and our plan is to record these assets for financial reporting purposes in the June 30, 2005 Comprehensive Annual Financial Report.